Fiscal Deficits and the Interest Rate

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There is no reason why larger borrowing by the government need raise interest rates in the economy. Is it a case of prejudice in favour of "small" government that is the reason for the continued currency of this view? Or even if the expressed view is due to a desire to keep foreign institutional investors happy, should it not be better to control speculative capital directly instead of recommending deflationary fiscal policies in the midst of a recession?

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One popular expectation from the newly-elected central government is that it would be more aggressive than its predecessor in counteracting the impact of the world recession on the Indian economy by pursuing an expansionary monetary and fiscal policy. Macro-economists have for long understood that in an economy facing a shortage of aggregate demand increased government expenditure helps everyone by raising incomes and output. It was this understanding that motivated governments across the world to respond with fiscal stimulus packages to the current economic slowdown. The last United Progressive Alliance government too announced measures of fiscal stimulus, but the continued slowing down of the Indian economy shows that they were not enough. Thus, the natural demand that the present government do more in the way of an expansionary fiscal policy.

A section of economists and the business press have, however, opposed any further expansion of government expenditure on the ground that such an expansion would be counterproductive. They argue that a larger fiscal deficit would raise interest rates in the economy, which, in turn, would reduce private expenditure, thereby negating at least a part of the increase in demand brought about by the higher government expenditure. No less a person than the Reserve Bank of India (RBI) governor, D Subbarao himself, has supported this argument. He is quoted as saying

> Large borrowings by the government run against the low interest rate environment that the Reserve Bank is trying to maintain to spur investment demand in keeping with the stance of monetary policy.[1]

We believe that that this argument, which pits expansionary fiscal policy against expansionary monetary policy, is based on incorrect economic reasoning. A higher fiscal deficit need not necessarily lead to an increase in interest rates. Believing otherwise and cutting government expenditure or not raising it enough in the midst of the worst world recession in recent times can only make economic conditions worse and impose unnecessary hardship on the people of the country.

Monetary vs Fiscal Policy

Before looking at the relationship between the fiscal deficit and interest rates it must be noted that even if there were a positive relationship between the two variables, it would not necessarily lead to a recommendation to curtail government expenditure in a time of economic slowdown. Even then, we would have to compare the relative effectiveness of fiscal and monetary policy. And it is quite possible that in this comparison fiscal policy would come out the winner. In the case of a fiscal stimulus, at least the direct demand does not depend significantly on the behaviour of the private sector. As regards monetary policy, low interest rates can boost demand only if the private sector is willing to borrow and invest, which it may not, given the pessimism that prevails in a recessionary environment. So, even if there were a contradiction between counter-recessionary monetary and fiscal policies, a high government expenditure-high interest rate regime might be preferable to a low government-low interest rate regime. But do we really face this dilemma?

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Prima facie it seems very plausible that a higher fiscal deficit would raise interest rates: the government borrowing more means an increase in the demand for credit and like any other market an increase in demand, everything else remaining constant, would lead to an increase in the market price, in this case the interest rate. The reason that this seemingly simple argument is flawed is that the pool of savings available in the economy is not fixed. If the government borrows more to finance higher expenditure, then "everything else" is no longer constant. The higher government expenditure leads to higher income and hence higher savings. Ultimately, the supply of credit increases by exactly the same amount as its demand

and there is no reason for the price of credit to increase. This has been known since Kahn and Keynes (Patnaik 2001).

Another way of seeing why it is wrong to link higher fiscal deficits to high interest rates is to note that the short-term nominal interest rate is not a market-determined price at all – it is an administered price of which RBI itself is the administrator. The interest rate at which RBI lends and borrows determines the interest rates which prevail in the economy. If the interest rate for private sector loans is significantly lower than what the RBI offers to those who lend to it, people would borrow from the private sector and lend to the RBI. If the interest rate for private sector loans is significantly higher than what the RBI charges from those who borrow from it, people would borrow from the RBI and lend to the private sector. Thus whatever interest rate the RBI charges on its loans becomes the interest rate which prevails throughout the economy.

Of course, loans made to the private sector would always carry a higher interest rate than loans to the RBI since private loans are risky whereas there is no risk in lending to the RBI. But since there is no reason why this risk premium demanded from the private sector would depend in any way on the level of the government's fiscal deficit, we ignore variations in it in our discussion below and assume that a change in RBI's interest rates translates into a one-is-to-one change in the interest rates for the private sector. We can also ignore for simplicity the lags that exist between changes in interest rates by the RBI and changes in retail interest rates.

So if the RBI wants interest rates to be low, it just needs to announce itself ready to lend and borrow at low interest rates. How much the government does or does not borrow should not have any impact on the effectiveness of this announcement. If the quantity of government bonds that are outstanding exceeds the amount of bonds people are willing to hold at the interest rate fixed by the RBI, they will offset this excess holding of bonds by borrowing an equivalent sum from the RBI.

One may object that borrowing from the RBI (which creates high powered money) is not a perfect substitute for government bonds. In our response, we distinguish between short-term and long-term government bonds. The only difference between short-term bonds and money is that the latter is slightly more liquid, i e, slightly more acceptable in exchange. However, in an economy like ours with developed financial markets this liquidity advantage is likely to be small and therefore substitution between money and short-term government bonds is unlikely to have large consequences. Moreover, this "monetisation" is a consequence of the low interest rate policy, something which is not being questioned by those like the RBI governor who want lower fiscal deficits. The case of long-term bonds is different, since holding long-term bonds involves taking interest rate risk while holding money does not. So in case the government borrows by issuing long-term bonds the substitution argument made earlier in this paragraph may not hold. But what is happening in this case is a change in maturity structure of the net stock of financial assets in the economy, a policy instrument different from that of low interest rates that we have been discussing.

Sometimes the case for a high fiscal deficit raising interest rates is presented in terms of increased government borrowing pre-empting a larger proportion of the total credit available in the economy. First, we have argued that the supply of credit by the private sector is not fixed, it increases when private incomes increase as a result of higher government expenditure. Further, so far in our argument we have assumed that the RBI is willing to lend and borrow as much as the private sector demands at the interest rate it has fixed. The amount of credit available in the economy can therefore be restricted only if either RBI actually restricts the amount it is willing to lend or if not all agents in the private sector have access to the RBI's borrowing window and those who do have access are not willing to borrow on behalf of those who do not.

In the first case, where the RBI is lending too little, the remedy is simple – the RBI needs to lend more rather than asking the government to borrow less. The second case is more realistic and interesting. As things stand, only banks can borrow from the RBI. It may be the case that banks refuse to lend to the rest of the private sector, instead deciding to hold government bonds. But in this case the excess holding of government bonds is just the symptom, the real problem is banks refusing to lend to businesses. Trying to treat just the symptom by restricting the stock of government bonds will be counteracted by banks running down their reserves or by their turning around and lending to the RBI. The true cure would involve either making businesses creditworthy again, in which demand injection through fiscal stimulus can only help, or in more extreme cases by the central bank opening up its borrowing window to a larger class of private agents, as the US Fed seems to be doing.

Thus, there is no reason why larger borrowing by the government need raise the short-term nominal rate of interest. It may once again be argued that what matters for the investment expenditure is not the short-term nominal rate but the long-term real rate of interest. However, this poses no new difficulty. By arbitrage, the return on long-term bonds is a product of a sequence of returns on short-term bonds,

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the latter being determined, as we have argued, by central bank policy. The nominal interest rate differs from the real interest rate by the expected rate of inflation. So, unless budget deficits today create expectations of an increase in short-term rates in the future and/or expectations of a deflation, neither of which is economically plausible, there is no reason why the long-term rate should increase either.

Conclusions

If there is no economic reason for a fiscal deficit to raise interest rates, and this fact has been known to macro-economists for the greater part of a century now, why does this belief still persist? One possibility is the stronghold of prejudice, in this case the prejudice in favour of a small government, among even those who are otherwise highly trained.

This prejudice does its harm not just through its hold on policymakers. In an economy open to capital flows, the prejudices of speculators – including the prejudice against fiscal deficits – may influence the decisions and statements of policymakers who are themselves right-thinking but who are scared of capital flight. But in that case, would it not be better to control footloose capital directly rather than placating it by placing restrictions on a democratically elected government and imposing real costs on the people of the country by recommending deflationary fiscal policies in the midst of a recession?

NOTE

1 "RBI Guv Sees Revival by the End of This Year", *The Economic Times*, Kolkata, 23 May 2009.

REFERENCE

Patnaik, Prabhat (2001): "On Fiscal Deficits and Real Interest Rates", *Economic & Political Weekly*, 36(14-15), 7 April.